DESCRIPTION OF H.R. 1049

(THE UTILITY RATEPAYER REFUND ACT OF 1987)

Scheduled for a Public Hearing

Before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

of the

COMMITTEE ON WAYS AND MEANS

On December 14, 1987

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

December 11, 1987

JCX-23-87

J867-47
H7852

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of H.R. 1049 (introduced by Messrs. Dorgan, Gephardt, Coyne, and others), a bill to repeal the 1986 Act's requirement that excess deferred tax reserves be normalized by public utilities. The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on the bill on December 14, 1987.

The first part of the document is a summary of present law and the bill. The second part provides a brief description of normalization and flow-through accounting. The third part provides a more detailed description of H.R. 1049 and the present-law normalization requirement and the bill, and part four discusses certain issues arising in connection with the possible repeal of the normalization requirement for excess deferred tax reserves.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of H.R. 1049 (The Utility Ratepayer Refund Act of 1987) (JCX-23-87), December 11, 1987.

I. SUMMARY

Normalization is a method to account for tax incentives to capital investment as they apply to regulated utilities. Normalization accounting as applied to accelerated depreciation requires adjustments to the regulatory tax expense and rate base to account for expected future Federal tax liability. The accumulation of the differences between regulatory tax expense and Federal tax liability creates a deferred tax reserve.

For purposes of computing Federal income tax expense in setting rates and computing operating results in regulated books of account, the Tax Reform Act of 1986 requires public utilities to normalize the portion of their deferred tax reserve that is considered as excess due to the 1986 Act reduction in corporate income tax rates. This excess deferred tax reserve, which represents taxes that previously have been charged to ratepayers (but which have not been paid to the Federal Government and will not be paid to the Federal Government if the corporate tax rates are not increased in the future) is considered to be normalized only if the reserve is reduced over the remaining regulatory lives of the property that gave rise to the reserve.

If the excess deferred tax reserve is not normalized as required by the 1986 Act, then the depreciation of public utility property for Federal income tax purposes must be determined by using the same depreciation method and period as is used for purposes of setting rates and reflecting operating results in the regulated books of account of the public utility.

H.R. 1049 would repeal retroactively the normalization requirement of the 1986 Act that applies to excess deferred tax reserves. Thus, under H.R. 1049, the method of depreciating public utility property for Federal income tax purposes would not be affected by the manner in which excess deferred tax reserves are taken into account by public utility commissions in establishing utility rates.

II. OVERVIEW OF NORMALIZATION AND FLOW-THROUGH ACCOUNTING

State public utility commissions consider various costs of regulated utilities, such as labor, fuel, materials, depreciation, interest expense, and return on invested capital, in determining appropriate utility rates. The Federal income tax expense of regulated utilities is one of the costs considered by State utility commissions in setting utility rates.

The use of an accelerated depreciation method for Federal income tax purposes results in an actual Federal income tax liability that differs from the Federal income tax liability that would have been incurred if the typically slower depreciation methods used for regulatory purposes had been used for tax purposes. In general, in the first few years after an item of property has been placed in service, the Federal income tax liability will be lower than if the regulatory depreciation schedule had been used. The Federal income tax liability will be greater in later years when the tax depreciation allowances are less than the regulatory depreciation allowances.

Flow-through accounting treats the actual Federal income tax liability of the regulated utility as the utility's tax expense in determining appropriate utility rates. Under flow-through accounting, the tax benefits of accelerated depreciation are taken into account immediately in determining utility rates. In contrast, under normalization accounting, adjustments are made to the regulatory tax expense and the rate base of public utilities in order to spread the tax benefits of accelerated depreciation over the regulatory life of the property. Generally, under normalization accounting, the utility's tax expense for ratemaking purposes is determined by using regulatory depreciation allowances.

Normalization methods for accelerated depreciation require adjustments to the regulatory tax expense and rate base to account for the expected future Federal tax liability. The accumulation of the differences between regulatory tax expense and Federal tax liability creates a deferred tax reserve. Reductions in tax rates, as occurred due to the Tax Reform Act of 1986, will cause the amount of the deferred tax reserve to exceed the amount which would have been placed in the deferred tax reserve if the lower tax rates had applied during the complete life of the asset. The difference between the deferred tax reserve and what would have been deferred if the lower tax rates had always prevailed, is known as the excess deferred tax reserve. Normalization, as applied to the excess deferred tax reserve, passes through the amount of this reserve over the regulatory life of the asset.

III. DESCRIPTION OF H.R.1049 (The Utility Ratepayer Refund Act of 1987)

Present Law

Normalization of tax benefits derived from ACRS

In order for public utility property to be eligible for the more favorable depreciation allowances available under the accelerated cost recovery system ("ACRS"), the tax benefits of ACRS must be normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account. Under present law, the tax benefits of ACRS are considered to be normalized only if three requirements are satisfied.

First, the tax expense of the public utility for ratemaking purposes must be computed by using the same depreciation method that is used in determining depreciation for ratemaking purposes and by using a useful life that is no shorter than the useful life used in determining depreciation for ratemaking purposes (which generally results in depreciation being determined over a relatively long useful life and using the straight-line method).

Second, the difference between the actual tax expense computed using ACRS and the tax expense determined for ratemaking purposes must be reflected in a deferred tax reserve.

Third, in determining the rate of return of a public utility, the public utility commission may not exclude from the rate base an amount that exceeds the addition to the deferred tax reserve for the period used in determining the tax expense for ratemaking purposes.

Under present law, public utility property is defined as property used predominantly in the trade or business of furnishing or selling (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, (3) telephone services, (4) other communications services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or (5) transportation of gas or steam by pipeline, if the rates for furnishing or selling are established or approved by certain regulatory bodies.

Normalization of tax benefits derived from the investment tax credit

The Tax Reform Act of 1986 repealed the regular investment tax credit ("ITC") generally for property placed in service after December 31, 1985. Nevertheless, if the tax

benefits of previously allowed ITCs (or ITCs allowed pursuant to certain transitional exceptions to the 1986 Act) on public utility property are not normalized in establishing utility rates for taxable years beginning after December 31, 1985, then certain ITCs will be recaptured.

In general, the amount of the ITCs that will be recaptured is the greater of (1) all ITCs allowed for taxable years that are not barred by the statute of limitations, or (2) the amount of the unamortized credits of the taxpayer or the credits not previously restored to rate base (whether or not for open years), whichever is applicable. If ITCs are being carried forward, the carryforward amount is reduced in lieu of recapture. Similar rules apply if the tax benefits of previously allowed employee stock ownership credits are not normalized.

In order for the tax benefits of the ITC to be normalized, the benefits may not be flowed through to customers more rapidly than would be allowed under either (1) the ratable flow-through method or (2) the rate base reduction method.

Under the ratable flow-through method, a pro rata portion of the credit is passed through to ratepayers during each year of the useful life of the property that generated the credit. The rate base may not be reduced by any amount to reflect the credit, and, thus, the shareholders of the public utility are allowed to earn a return on the cost of equipment that has been, in effect, supplied by the Federal Government through the credit.

Under the rate base reduction method, the rate base is reduced by the amount of the credit, and, thus, the shareholders of the public utility are prevented from earning a return on the cost of equipment that has been paid for by the credit. Under this method, the amount of the reduction must be restored to the rate base not less rapidly than ratably over the useful life of the property that generated the credit. In addition, no portion of the credit may be passed through to ratepayers directly as a reduction to cost of service or indirectly by reducing the depreciable basis of the property for ratemaking purposes by any portion of the credit.

Normalization of excess deferred tax reserve

In general

The Tax Reform Act of 1986 reduced the maximum corporate income tax rate from 46 to 34 percent, effective on July 1, 1987. In addition, the 1986 Act requires public utilities to normalize the portion of their deferred tax reserve that is attributable to use of accelerated depreciation for Federal

income tax purposes and that is defined as excess due to the 1986 Act reduction in corporate income tax rates. If the excess deferred tax reserve is not normalized as required by the 1986 Act, then, for Federal income tax purposes, public utility property must be depreciated using the depreciation method, useful life determination, averaging convention, and salvage value limitation that is used for purposes of setting rates and reflecting operating results in the regulated books of account of the public utility.

Definition of excess deferred tax reserve

In normalizing the tax benefit derived from the use of ACRS (or other accelerated method of depreciation), the difference between the actual tax expense computed using ACRS (or such other accelerated method of depreciation) and the tax expense determined for ratemaking purposes must be reflected in a deferred tax reserve on the books of account of the public utility. The excess deferred tax reserve equals the excess of (1) the balance of the deferred tax reserve as it existed immediately before the enactment of the 1986 Act, over (2) what the balance of such deferred tax reserve would have been if the amount of the reserve was determined by assuming that the corporate income tax rate reductions provided by the 1986 Act were in effect for all prior periods.

Normalization method

The excess deferred tax reserve is normalized under the 1986 Act only if, in setting utility rates and reflecting operating results in the regulated books of account, the reserve is not reduced more rapidly than such reserve would be reduced under an "average rate assumption method." The average rate assumption method is a method that reduces the excess deferred tax reserve over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes.

Under the average rate assumption method, the excess deferred tax reserve is reduced as the depreciation timing differences (i.e., the differences between tax depreciation and regulatory depreciation with respect to each item of property or class of property in the case of vintage accounts) reverse over the life of the property. The reversal of depreciation timing differences generally occurs when the amount of the tax depreciation with respect to an item of property is less than the amount of the regulatory depreciation with respect to the same item of property. The excess deferred tax reserve is multiplied by a ratio that is designed to assure that the reserve is reduced to zero at the end of the regulatory life of the property that generated the reserve.

The normalization requirements of the 1986 Act do not apply to any excess deferred tax reserve generated from previous reductions in corporate tax rates or from other sources of deferred taxes. These excess deferred tax reserves will continue to be treated under prior law.[2]

Explanation of the Bill

The bill would repeal the requirement for the normalization of excess deferred tax reserves for public utility property to qualify for accelerated tax depreciation methods. The bill, in effect, would permit public utility commissions to flow through to utility rates the excess deferred tax reserve in any manner desired without endangering the use of accelerated tax depreciation for public utility property.

Effective Date

The provisions of the bill would be effective as if the original requirements for the normalization of excess deferred tax reserves in the Tax Reform Act of 1986 had never been enacted.

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[2] In Private Letter Ruling 8544061, the Internal Revenue Service ruled that the ACRS normalization requirement would not be violated if the excess deferred tax reserve that resulted from the 1979 Act reduction in corporate rates was returned to ratepayers over a three-year period.

IV. ISSUES CONCERNING THE NORMALIZATION OF EXCESS DEFERRED TAX RESERVES

Background

Public utility regulation by States is premised on the belief that utilities, without regulation, would earn "monopoly" profits at the expense of the consumer. State public utility commissions attempt to ensure reasonable utility rates for consumers while providing a fair return on investment for utilities. Costs for ratemaking purposes include costs of operation, depreciation, taxes, and an allowed rate of return on capital. One of the important issues for utility ratemaking is determining the allocation over time of costs associated with capital. In general, regulatory depreciation allowances are less generous than depreciation allowances for tax purposes.

Accelerated depreciation methods in the Internal Revenue Code serve to reduce tax payments early in a property's life while increasing by the same amount tax payments later in the property's life, relative to less accelerated methods. This shifting of tax liability to later in a property's life acts as an interest-free loan from the Government to the owner of the property.

Normalization accounting methods adjust costs for certain differences between tax and regulatory accounting. Normalization as applied to accelerated tax depreciation attempts to distribute over the life of the asset the benefit to consumers of the interest-free loan for ratemaking purposes.

Excess deferred tax reserves arise from the maximum corporate tax rate reduction from 46 to 34 percent in the Tax Reform Act of 1986. The tax rate reduction effectively acts as a windfall forgiveness of a portion of the interest-free loan which the taxpayers owe the Government from the use of accelerated depreciation. The amount of forgiveness is accounted for in the excess deferred tax reserve.

Neutrality with unregulated taxpayers

Unregulated taxpayers as well as regulated utilities receive a benefit from the reduction in corporate tax rates to previously invested capital on which accelerated tax depreciation deductions have already been taken. This is because investment before the tax rate reduction was made with the expectation of higher tax rates than eventually prevailed. Early, large tax depreciation allowances due to accelerated depreciation methods sheltered income at high tax rates. After tax rates decline, income is taxed at a rate lower than expected.

The benefit of lower tax rates as it applies specifically to investments made before the tax rate reduction may be retained solely by the owners of these assets in unregulated industries rather than being passed through to consumers in the form of lower prices. To the extent it is desirable to treat regulated utilities similarly to unregulated corporations, some people suggest that requiring either a fast flow-through or normalization treatment of the excess deferred tax reserve is inappropriate; instead they suggest that the benefit should be permitted to accrue to owners of utility property as it could to owners of unregulated property.

On the other hand, many people believe that one purpose of utility regulatory commissions is to prevent the earning of unwarranted "excess" profits by the regulated utility at the expense of ratepayers. The windfall benefit from lower tax rates which accrues to previously invested capital may be viewed as one source of excess profit. Generally, utility regulatory commissions remove the deferred tax reserve from the rate base for determining the allowed return to invested capital. In this view, as long as the excess deferred tax reserve continues to be excluded from the rate base on which a return to invested capital is provided by the utility commission, no additional ongoing excess profit is earned by the regulated utility from the decrease in tax rates.

However, some of these people would treat the amount of unforeseen benefit of the tax rate reduction as reflected in the excess deferred tax reserve itself as an "excess" benefit. In this view, the excess deferred tax reserve represents unwarranted past payments made to the utility by the ratepayers. Thus, it still may be appropriate to rebate this amount to ratepayers through lower future utility costs. The normalization of excess deferred tax reserve in present law serves as one method for passing this benefit through to the ratepayers.

Intertemporal neutrality

One view of the purpose of normalization is to spread across the service life of utility property the benefit to consumers of Federal tax subsidies for capital investment. More immediate flow-through treatment of investment incentives typically produces lower utility rates early in a property's life and higher rates later on. Normalization generally acts to reduce the intertemporal variation in utility rates due to tax effects relative to flow-through, thus smoothing over time the benefits to consumers.

In order for utility property to continue to qualify for accelerated depreciation methods, present law limits the particular method in which excess deferred tax reserves

attributed to the corporate rate cuts enacted in 1986 may be reflected in lower utility rates. H.R. 1049 would remove this limitation, and would permit State public utility commissions to take into account the excess deferred tax reserve for ratemaking purposes in any manner.

Assuming that some public utility commissions would be likely to accelerate the pass through of the amount of excess deferred tax reserve for ratemaking purposes, the pattern of utility rates over time compared to present law could be altered. Faster pass through of the excess deferred tax reserve would lead to lower utility rates in the near future, but as the excess deferred tax reserve was reduced, rates would be higher in the more distant future than under present law.

One could view the excess deferred tax reserve as arising because ratepayers in the past paid higher utility rates than they would have if the lower tax rates had been foreseen. From this standpoint, normalization of the excess deferred tax reserve will return the excess rate collections from past ratepayers gradually to future ratepayers. To the extent it is desirable to provide benefit primarily to ratepayers who paid higher utility rates in the past than would have been necessary if the tax rate cut had been foreseen, one may want to accelerate the pass through of the reserve. The longer the period over which the excess deferred tax reserve is passed through, the more likely that the set of consumers receiving the benefit will differ from those who bore the earlier, higher utility rates.

Incentives for investment

Another view of the purpose of normalization is to ensure that the capital subsidy of accelerated depreciation in the Federal tax code is an incentive to investment for regulated utilities. Present-law normalization requires that the portion of the reserve for future taxes that is forgiven due to the tax rate cut be passed through to consumers over the life of the asset rather than only to consumers in the initial years after the rate cut. This pattern may be similar to the pattern of future tax payments to the Government which would have occurred if the tax rate reduction had not happened, except the payment of the excess deferred tax reserve will now made to consumers through lower utility rates instead of to the Government.

Some would argue that since the excess deferred tax reserve due to the tax rate cuts enacted in 1986 arises only from past investment, the manner in which the excess deferred tax reserve is passed through to the rate base may have no effect on investment incentives of the utility. However, to the extent that future tax rate cuts are anticipated by the utility, faster pass through of excess deferred taxes may

reduce the incentive for future capital investment by the utility in anticipation that similar treatment will occur again in the future.

Cash flow effects

Alternative methods of passing through the excess deferred tax reserve to the ratemaking process will alter the cash flow of the utility company. Earlier pass through of the excess deferred tax reserve will reduce the cash flow of the utility and may require the utility to increase its external financing for investment.

To the extent that reduced cash flow and increased borrowing by the utility increase the cost of funds, earlier pass through of the excess deferred tax reserve may increase the cost of future utility service. If the cost of new funds exceeds the rate of return allowed by utility commissions, then any increased borrowing resulting from faster pass through of the reserve will either increase the cost to consumers because of the need for a higher allowed rate of return by utility commissions, or else reduce profits for owners of regulated utilities.

State utility regulation and Federal tax policy

Some would argue that it is inappropriate for Federal tax policy to attempt to influence State public utility commissions in the manner in which they set rates. Moreover, it is suggested that because of the ability to alter the allowed rate of return to invested capital, public utility commissions are not greatly restricted by the existing normalization requirements in the way in which they pass through the actual economic impacts of Federal tax investment subsidies.

Others believe that the tax benefit provided to utilities by accelerated depreciation in the Federal tax code makes it appropriate for Federal tax policy to determine the manner in which the benefit will pass through to ratepayers. The existing normalization provisions are reflective of this second viewpoint.